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No. 95-155

IN THE
Supreme Court of the United States
OCTOBER TERM, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

DELOITTE & TOUCHE LLP,
Petitioner,
v.

ROSETTA MILLER, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

The American Institute of Certified Public Accountants (the "Institute") hereby respectfully moves for leave to file the attached brief as *amicus curiae* in support of Petitioner Deloitte & Touche LLP ("Petitioner"). The consent of the attorney for Petitioner was obtained.[1] The consent of the attorney for Respondents Rosetta Miller, *et al.*, was requested but refused.

The Petition raises issues of significant interest to the Institute and its members. Accountants increasingly find themselves the targets of class action securities litigation under Section 11 of the Securities Act of 1933. When newly issued securities decline in value, disgruntled in-

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[1] The written consent is being filed with the Clerk of the Court contemporaneously herewith.

vestors commonly invoke Section 11 in an attempt to recoup their losses from accountants and other perceived "deep pockets" who participated in the securities offering.

The decision below improperly expands the scope of potential liability under Section 11. Section 11(e) allows a defendant to avoid liability to the extent it is shown that the decline in the price of a security "resulted from" factors other than the alleged errors or omissions in the registration statement. The Ninth Circuit disregarded the plain language of the statute and adopted instead a broad common law notion of "loss causation" that allows for potential liability whenever an alleged error "relates to" or "touches upon" the reasons for a security's decline in price. The Ninth Circuit's "touch upon" approach supplants the proper analysis required under Section 11(e) and expands potential liability beyond the statute's express terms. As applied below, the "touch upon" approach leads to the anomalous result that an independent auditor alone remains potentially liable for declines in the price of a security, while the officers and directors of the issuer, who prepared the registration statement and issued the security, avoid any liability.

The Institute has been a long-standing and leading advocate of rules of law that establish fair and principled delineations of the scope of accountant liability.[2] Because the Institute's members must consider the risks of potential Section 11 liability when ordering their business practices, the Institute is vitally interested in this Court's review of the decision below to provide meaningful guidance on the proper construction of Section 11(e). The

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[2] The Institute has participated as an *amicus curiae* in other cases involving civil liability under the federal securities laws, including *Central Bank of Denver v. First Interstate Bank*, 114 S. Ct. 1439 (1994), *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 113 S. Ct. 2085 (1993), *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979), and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

Petitioner has argued a number of issues supporting the grant of *certiorari* in this case. The brief that the Institute seeks leave to file as *amicus curiae* joins those arguments but addresses more broadly the far-reaching implications that the Ninth Circuit's ruling may have on accountants, the investing public, and the financial markets if allowed to stand.

Respectfully submitted,

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Dated: August 24, 1995

QUESTION PRESENTED

Whether the "loss causation" defense, as codified by Congress under Section 11(e) of the Securities Act of 1933, 15 U.S.C. § 77k(e), is established where an auditor affirmatively shows that the decline in the price of a security "*resulted from*" factors other than the alleged accounting errors in the issuer's audited financial statements, as Section 11(e) expressly provides, or whether the Ninth Circuit properly disregarded the plain language of the statute to adopt instead a broader, common law notion of "loss causation" that permits potential liability where there was no disclosure of the existence of the alleged errors prior to suit (and thus the market could not have reacted to them one way or the other) and where the alleged errors merely "*relate to*" or "*touch upon*" the reasons for the decline in the security's price?

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BRIEF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

PRELIMINARY STATEMENT

The American Institute of Certified Public Accountants (the "Institute") submits this brief as *amicus curiae*, pursuant to Rule 37.2 of the Rules of this Court, in support of Petitioner Deloitte & Touche LLP ("Petitioner").

INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*

The Institute is the national organization of the certified public accounting profession, with more than 320,000 members. Institute members range from sole practitioners to members of large international firms. A primary objective of the Institute is the development of authoritative accounting, auditing, and ethical standards of prac-

tice. These standards include ones which, in conjunction with rules of the Securities and Exchange Commission ("SEC"), govern auditors in reporting on a company's financial statements in registration statements and other publicly filed disclosure documents.

The Institute and its members are vitally interested in this Court's review of the decision below to address the proper application of the "loss causation" defense available to auditors and others under Section 11(e) for alleged material errors in registration statements. SEC regulations require that registration statements include financial statements of the issuer. The financial statements are prepared by the issuer's management and, with limited exceptions, must be audited by an independent certified public accountant in accordance with generally accepted auditing standards developed by the Institute. The Institute's members routinely audit and report on clients' financial statements, pursuant to these requirements. These auditing services address the needs of the investing public for financial information, while facilitating the ability of companies to raise necessary capital.

Accountants are civilly liable under Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, for material errors in an audit report or other portions of a registration statement "certified" by the accountant.[1] Section 11(e), however, reduces liability to the extent that an accountant can show that the drop in the price of a security "resulted from" factors other than the alleged accounting errors. This "loss causation" defense provides an important safeguard against attempts by disgruntled investors to recoup their losses on a bad investment from perceived "deep pocket" accountants. The high degree of

[1] In fact, auditors do not "certify" or prepare their clients' financial statements. Management is responsible for the statements; auditors examine the statements in accordance with generally accepted auditing standards and issue a report, usually containing an opinion on management's presentation of the financial statements.

professional judgment involved in the auditing process makes accountants easy prey for allegations of "negligence by hindsight." Section 11(e), when properly applied, permits accountants to obtain early disposition of such claims by showing that the investors' losses did not "result from" the alleged auditing errors.

The decision below disregards the "results from" causation standard codified in Section 11(e) and adopts instead a broader, common law notion of "loss causation" that allows for potential liability whenever alleged accounting errors "relate to" or "touch upon" the reasons for a security's decline in price. Financial statements arguably "touch upon" virtually all aspects of a company's business. Little effort may be required to plead some relationship, however attenuated, between alleged errors in the financial statements on which an auditor reports and the business factors actually causing a decline in the price of a security. By failing to give proper effect to the plain language of Section 11(e), the Ninth Circuit has opened the door to expanded liability against accountants and other professionals who participate in securities offerings. Such expanded liability will likely lead to higher auditing costs, reduced availability of services, and other adverse consequences that Congress never intended in enacting Section 11. The Institute and its members respectfully urge this Court to review the decision below and provide much needed guidance to the courts and the public on the proper application of Section 11(e).

STATEMENT OF THE CASE

The decision below leaves an independent auditor potentially liable under Section 11 for reporting on allegedly misleading financial statements in a company's offering prospectus, while permitting the officers and directors of the company, who prepared the financial statements and issued the security, to avoid liability as a matter of law. The Respondents alleged below that the audited

financial statements and the debenture prospectus were materially misleading because they overstated the company's revenues and failed to disclose a liquidity crisis. *See* Petitioner's Appendix ("Pet. App.") at A-13-21. In particular, the Respondents claimed that the company had "engaged in various tactics to 'pump up' revenue figures without completing actual sales," including certain "price protection," "stock balancing," and "guaranteed sales" programs, and that the company's financial statements, which were audited by the Petitioner, improperly recognized revenue on sales transactions subject to these programs. *Id.* at A-18.

The Ninth Circuit affirmed summary judgment for the officers, directors, and underwriters of the company, finding that the alleged pricing and sales programs were either immaterial or adequately disclosed in the prospectus. The Ninth Circuit found that the Respondents had "introduced 'no evidence that [the company's] management could have foreseen that [the company] would have to reduce prices . . .'" after the debenture offering. *Id.* (citation omitted). "Thus, the alleged practice of price protection did not pose a foreseeable risk . . ." to investors, and the company had no duty to disclose it. *Id.* (citation omitted). The Ninth Circuit also held that "[t]he speculative impact of future exchanges and price reductions was not material." *Id.* at A-18-19 (citation omitted).

In addition, the Ninth Circuit found that price protection and stock balancing programs were "commonplace" in the relevant industry and that the company thus "had no duty to disclose its observance of those practices." *Id.* at A-19 (citation omitted). The Respondents' allegations concerning the company's guaranteed sales program were equally unfounded. "The [Respondents'] evidence of guaranteed sales is speculative, nebulous, and nowhere purports to quantify the degree to which [the company] engaged in this 'normal business' practice. As such, it does not rise to the level of a material omission." *Id.* at A-20 (citation omitted).

Despite these findings, the Ninth Circuit held that a genuine issue of fact remained as to whether the Petitioner might still be liable under Section 11 for alleged errors in the audited financial statements. *Id.* at A-33-34. The district court found that the Petitioner had affirmatively shown that the drop in the price of the debentures "resulted from" factors other than the alleged revenue recognition errors in the company's audited financial statements. These "other factors" included disclosures by the company of a liquidity crisis, a decline in sales, a general slump in the market, and other events occurring *after* the offering. *Id.* at B-37-38.

The Petitioner further established that there had been no disclosure of the existence of any alleged accounting errors during the relevant period. Indeed, the Respondents' complaint contained the *only* allegation ever made that the Petitioner had erred in reporting on the company's financial statements in the registration statement. The timing of the disclosures was critical, since the measure of damages under Section 11 is the difference between the amount paid for a security at the time of purchase and the price of the security at the time suit is brought. 15 U.S.C. § 77k(e) (1995). Because the alleged errors were first disclosed at the very time the Respondents filed suit, the market could not have reacted to them for purposes of the Respondents' Section 11 damages claims. Pet. App. at B-37.

Although the Ninth Circuit agreed that the drop in the price of the debentures did not "*result from*" any disclosure of the alleged errors in the financial statements, it nonetheless found that the company's various post-offering disclosures, which did cause the drop in price, "*directly related* to the transactions for which [Petitioner] allegedly made erroneous accounting determinations . . . ." *Id.* at A-32. Because the alleged errors in the financial statements "touched upon" the reasons for the drop in the price of the debentures, the Ninth Circuit concluded that summary judgment in favor of the Petitioner was

inappropriate. *Id.* at A-32-34. The Ninth Circuit reached this conclusion notwithstanding its earlier findings that the various pricing and sales programs at the heart of the alleged accounting errors were either immaterial or adequately disclosed, and thus provided no basis for liability against the officers, directors, and underwriters of the company.

REASONS FOR GRANTING THE WRIT

I. THE ISSUES PRESENTED TRANSCEND THE INTERESTS OF THE PARTIES AND ARE OF VITAL IMPORTANCE TO THE INSTITUTE AND ITS MEMBERS.

A. Accountants Perform An Indispensable Role In Our Financial Marketplace.

Proper application of the "loss causation" defense, as codified in Section 11(e), is critically important to certified public accountants. The Securities Act of 1933 requires issuers of publicly offered securities, with few exceptions not relevant here, to register those securities with the SEC and to make certain disclosures in connection with the offering in a registration statement. 15 U.S.C. § 77f (1995).[2] These disclosure requirements include the filing of audited consolidated balance sheets as of the end of each of the two most recent fiscal years, 17 C.F.R. § 210.3-01(a) (1994), and statements of income and changes in financial position for each of the three fiscal years preceding the date of the most recent audited balance sheet (or any shorter period for which the registrant has been in existence). 17 C.F.R. § 210.3-02(a). The financial statements must be audited by an independ-

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[2] The SEC has standardized and codified the form and content of the financial statements required for inclusion in registration statements in Regulation S-X. *See* 17 C.F.R. pt. 210 (1994). Harold S. Bloomenthal & Holme Roberts & Owen, *Securities Law Handbook* § 3.07 (1995).

ent certified public accountant [3] and accompanied by an accountant's report.[4]

The SEC has relied primarily on the accounting profession to set the standards for these financial disclosure requirements. Thus, despite the SEC's authority to promulgate its own set of rules governing accounting standards, it has deferred instead to the generally accepted accounting principles ("GAAP") developed by the Institute and its members. 2 Louis Loss & Joel Seligman, *Securities Regulation* 698 (3d ed. 1989). Financial reports contained in registration statements are presumed to be inaccurate if not prepared in accordance with GAAP. 17 C.F.R. § 210.4-01(a)(1).

Through their role in this mandatory disclosure process, independent public accountants help to promote the accuracy of the financial data available to investors in the securities markets, while facilitating companies in the raising of new capital for operations and expansion. This Court has recognized that the role of accountants in reporting on financial data is crucial to the effective functioning of the federal securities laws. *Central Bank of Denver v. First Interstate Bank*, 114 S. Ct. 1439, 1454 (1994) ("*Central Bank*"). The continued availability of

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[3] In certain instances, interim balance sheets and income statements for the current fiscal year (or part thereof) must be filed, but these interim financial statements need not be audited. 2 Louis Loss & Joel Seligman, *Securities Regulation* 689-91 (3d ed. 1989).

[4] The report must (1) state whether the audit was made in accordance with generally accepted auditing standards and designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case, which have been omitted, and the reasons for their omission; and (2) state (a) the opinion of the accountant with respect to the financial statements covered by the report and the accounting principles and practices reflected therein and (b) the opinion of the accountant as to the consistency of the application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements. 17 C.F.R. § 210.2-02(b) & (c).

these required auditing services is indispensable to the financial markets.

B. The Audit Process Is Complex And Involves The Exercise Of Professional Judgment.

The auditing services performed by accountants in the registration process are complex and involve the exercise of substantial professional judgment. Corporate financial statements are prepared by management, not by the auditors. "As a matter of commercial reality, audits are performed in a client-controlled environment. The client typically prepares its own financial statements; it has direct control over and assumes primary responsibility for their contents." *Bily v. Arthur Young & Co.*, 834 P.2d 745, 762 (Cal. 1992) (citations omitted) ("*Bily*").

The auditor's role is to conduct what is, in his or her professional judgment, an appropriate series of inquiries to reach an independent opinion as to whether the statements "fairly" present "in all material respects, [the company's] financial position, results of operations, and its cash flow in conformity with [GAAP]." AICPA Professional Standards AU § 110.01 (AICPA 1991). In forming an opinion, accountants cannot test every transaction a company entered into over the period covered by the audit or independently value every one of the client's assets and liabilities. The auditor thus initially surveys the client's business operations and accounting systems and makes decisions as to the scope of the audit and the methods and procedures to be used. AICPA Professional Standards AU § 311.01 (AICPA 1994). Throughout the process, procedures are re-evaluated and modified to reflect information obtained by the auditors.[5]

The end result, an audit report, "is not a simple statement of verifiable fact that . . . can be easily checked against uniform standards of indisputable accuracy . . . .

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[5] *See* Willis W. Hagen, II, *Certified Public Accountants' Liability for Malpractice: Effect of Compliance With GAAP and GAAS*, 13 J. Contemp. L. 65, 67-68 (1987).

Although ultimately expressed in shorthand form, the report is the final product of a complex process involving discretion and judgment on the part of the auditor at every stage." *Bily*, 834 P.2d at 763. *See also* Jerry Sullivan et al., *Montgomery's Auditing* 19 (1985) ("reasonable preparers of financial statements and auditors can disagree" about the application and interpretation of accounting principles).

The nature of the auditing process thus makes accountants especially prone to second guessing and allegations of "negligence by hindsight" when a new security loses value. *See Bily*, 834 P.2d at 763 ("Using different initial assumptions and approaches, different sampling techniques, and the wisdom of 20-20 hindsight, few CPA audits would be immune from criticism.") (citation omitted). As explained by one observer:

> Today, when new issues decline, resourceful plaintiffs' counsel place the prospectus under a veritable legal microscope, scrutinizing every clause and number in the light of subsequent experience. Everything that fails this test of hindsight then reappears in a securities class action complaint, which often consists of dozens of alleged inaccuracies and omissions concerning every conceivable aspect of the issuer's operations.

Robert A. Spanner, *Limiting Exposure in the Offering Process*, The Review of Securities & Commodities Regulation, Vol. 20, No. 7, at 59 (Apr. 8, 1987).

C. The Ability To Obtain Summary Disposition Of Meritless Section 11 Claims Is Critically Important To Accountants.

Section 11 is a narrowly-drawn provision that exposes accountants and others who participate in the registration of securities to a form of strict liability for alleged errors in the offering documents. Congress imposed stringent liability under Section 11 to promote compliance with the disclosure requirements of the 1933 Act.

See Harold S. Bloomenthal et al., *Emerging Trends in Securities Law* § 3.02[1] (1995). The provision expands potential liability "significantly beyond that of the common law." Arthur J. Marinelli, *Accountants' Liability To Third Parties*, 16 Ohio N.U. L. Rev. 1, 1[illegible] (1989). Privity is not a necessary element under Section 11, there is no requirement of scienter, and proof of reliance is largely eliminated. *Id.*

To offset this stringent liability, Congress provided a number of defenses under Section 11, including a materiality requirement and a due diligence defense. *Id.* at 11-12. In addition, Section 11(e) provides that a defendant is not liable for alleged errors or omissions in the offering documents to the extent it is shown that the decline in the price of a security "resulted from" factors other than the alleged misrepresentations. This "loss causation" defense provides an important safeguard against potentially unlimited liability for a security's decline in price.

1. *The Number And Magnitude Of Public Offerings Already Pose Tremendous Liability Risks Under Section 11.*

Modern securities offerings commonly involve hundreds of millions of dollars and tens of thousands of investors. The number and magnitude of recent registration statement filings with the SEC demonstrate this point:

Year	No. of Offerings [6]	Amount (in billions)
1991	2,964	$461.7
1992	3,815	$723.9
1993	4,537	$785.9
1994 (Jan.-Apr.)	1,435	$222.5

Source: Securities Exchange Commission Division of Corporate Finance, *Weekly Statistical Report*, May 13, 1994, at PG-8-8A.

[6] Includes registration statements filed under the 1933 Act and S-4/F-4 filings.

Initial public offerings of stock ("IPOs"), generally involving issuances in the newest and riskiest companies, represent a significant portion of this registration activity. The number of recent IPOs increased from 468 in fiscal year 1992 (July 1, 1991-June 30, 1992) to 820 in fiscal year 1994 (July 1, 1993-June 30, 1994). *See* The Emerson Company, *1994 Auditor Change Report for the Period July 1, 1993 to June 30, 1994* (July 5, 1994).

When new ventures fail or perform below expectations, disgruntled investors increasingly turn to Section 11 as a means for attempting to recover on their lost investments. One observer recently reported on this trend:

> Some transactions, like public offerings, generate litigation whenever investors have lost an amount sufficient to support an award of attorney's fees. A study of public offerings in one industry thus found that where damages above a certain floor could be claimed and financially sound defendants were available, a class action based on allegations of misrepresentation or inadequate disclosure was brought on *every* occasion that the value of newly-issued stock was, within fifteen months after the offering, less than its offering price.

Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 Duke L.J. 945, 949-50 (1993) (citations omitted) ("*Raising the Cost of Capital*"). *See also* Robert A. Spanner, *A Litigation Perspective on the Prospectus Preparation Process for an Initial Public Offering*, 16 Sec. Reg. L.J. 115, 118 (1988) ("when newly public companies stumbled in the marketplace, the laboratory, or the stock market, investors proved eager to find someone to blame, and IPO securities class actions became so numerous that even the business press took notice.") (citations omitted) ("*A Litigation Perspective*").

Accountants are particularly vulnerable to such suits because they often are the only solvent "deep pockets" left. *See* Thomas McCarroll, *Who's Counting?*, Time, Apr. 13, 1992, at 48, 49 ("[p]eople come after the auditors because they're usually the only ones with money left standing.") (quoting Philip Chenok, past president of the Institute) ("*Who's Counting?*"). Moreover, the trend toward use of Section 11 against accountants is likely to increase in light of this Court's recent decision in *Central Bank*, which confines liability under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1995), to primary violators of the statute. *Cf.* Steven Thel, *Section 12(2) of the Securities Act: Does Old Legislation Matter?*, 63 Fordham L. Rev. 1183, 1184-85 (1995) (discussing increased use of Section 12(2) by class action plaintiffs after *Central Bank*).

2. *The "High Stakes" Nature Of Section 11 Cases Often Forces Accountants And Other Defendants To Settle Even The Most Meritless Of Claims.*

The stringent liability imposed under Section 11 exposes accountants and others who participate in these transactions to potentially staggering damages claims. Section 11 cases are typically brought as class actions on behalf of all investors in the offering. Damages claims may range from a portion of the security's offering price to the full amount. *See A Litigation Perspective*, 16 Sec. Reg. L.J. at 119 ("Exposure in Section 11 actions can be staggering—up to the entire amount of the offering.").

The sheer magnitude of potential liability under Section 11 "makes trial unattractive to defense counsel no matter how unmeritorious the action." *Id.* at 120. "[C]asual empiricism suggests that these suits are almost always settled, and typically for more than nominal amounts. This is hardly surprising given the staggering potential exposure in open market securities cases and

the enormous cost of litigation. As a result, the rational strategy will frequently be to settle, even in cases that lack merit." Daniel R. Fischel, *The Regulation of Accounting: Some Economic Issues,* 52 Brook. L. Rev. 1051, 1054 (1987) ("*Regulation of Accounting*").

It thus is critically important, as this Court has recognized, that accountants and others be able to obtain early disposition of meritless Section 11 claims. Without the ability to mount these early defenses, accountants remain prey to the "settlement value" of vexatious securities litigation. *Cf. Central Bank,* 114 S. Ct. at 1454; *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 742-43 (1975).[7]

The Ninth Circuit's expansive "touch upon" approach to Section 11(e) in this case prevented the Petitioner from obtaining summary disposition of the damages claims, notwithstanding the court's findings that the debenture's decline in price was caused by the disclosure of events that took place *after* the offering. This result is particularly anomalous since the Petitioner, an independent auditor, remains potentially liable for the alleged errors in the registration statement, whereas the officers, directors, and underwriters of the company, who prepared the registration statement and issued the debentures, have avoided any liability.

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[7] *See also Raising the Cost of Capital,* 42 Duke L.J. at 950 ("there is increasing evidence that settlement is inevitable where judgment on the pleadings or a quick summary judgment cannot be obtained, and that the amounts paid in settlement are in large part unrelated to the merits of the action."); Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions,* 43 Stan. L. Rev. 497, 569 (1991) ("[g]etting the claim into the legal system, without more, sets in motion forces that ultimately compel a multi-million dollar payment.").

II. THE DECISION BELOW IMPROPERLY EXPANDS LIABILITY UNDER SECTION 11 BY ADOPTING BROAD COMMON LAW NOTIONS OF "LOSS CAUSATION" IN DISREGARD OF THE PLAIN LANGUAGE OF THE STATUTE.

This Court's decision in *Central Bank*, 114 S. Ct. at 1447, requires that liability under the federal securities laws must be determined based on the plain language of the statutes. The Petition fully addresses how, prior to the decision below, courts have construed the plain language of Section 11(e) to require a direct causal connection between the alleged errors in a prospectus and the drop in the price of a security. *See* Petition at 11-13. These decisions have given effect to the common sense meaning of the "results from" language used by Congress in the provision and allowed accountants and others to obtain summary disposition of meritless Section 11 claims. *See, e.g., Akerman v. Oryx Communications, Inc.*, 810 F.2d 336, 342 (2d Cir. 1987); *In re Fortune Sys. Sec. Litig.*, 680 F. Supp. 1360, 1365 (N.D. Cal. 1987).

The Ninth Circuit disregarded the "results from" language of Section 11(e) and adopted instead a "relate to"/"touch upon" approach that greatly expands the scope of potential liability under the statute. Pet. App. at A-31. This "touch upon" approach, which the Ninth Circuit acknowledges is "broad" in nature, supplants the proper analysis required under Section 11(e) and expands potential liability beyond the statute's express terms.

Financial statements, for example, arguably "touch upon" virtually all aspects of a company's business. As a consequence, little effort may be required to plead some relationship, however attenuated, between alleged errors in the financial statements on which an auditor reports and the business/market factors actually causing a decline in the price of a security. If those business/market factors —and not the alleged accounting error—caused the decline in price, Section 11(e) makes clear that the auditor

is not liable for damages due to the alleged error, *regardless* of whether that error bears some relationship to or "touches upon" those other factors.

The perils of the Ninth Circuit's "touch upon" approach can be demonstrated by a few examples of factors that might cause a drop in the price of a security, and which arguably might be "touched upon" in a company's financial statements.

- A company states the value of unsold widgets in its financial statements. Subsequent to the auditor's report on those financial statements, a general decline in the market for widgets reduces the value of the inventory and causes the company's stock to drop in price. An alleged (but previously undisclosed) error in the audited financial statements on the value of the inventory would "touch upon" the reasons for the stock's decline; the drop "resulted from" market conditions, however, and not the alleged accounting error.

- An auditor fails to uncover an error concerning the age of certain accounts receivables from a major customer of the audit client. Before the error is discovered and disclosed, the customer files for bankruptcy and fails to pay on its account, causing a drop in the stock of the audit client. The drop in price did not "result from" the error in the financial statements, even though the error "touches upon" the reason for the decline.

- A company includes in its revenues sales of a consumer product to a major department store chain. The company mistakenly overstates the amount of the sales. Two months after the auditor's report on the financial statements, and before the error is found and disclosed, the product is reported to be dangerous by a consumer group and sales decline dramatically. The department store chain returns significant unsold inventory under a sales guarantee arrangement and the company's stock drops

> as a result. The error in the audited financial statements "touches upon" the reason for the decline, but the decline surely did not "result from" that error.[8]

By disregarding the "results from" language used by Congress, the Ninth Circuit's "touch upon" approach opens the door for unprincipled expansion of potential liability under Section 11. The decision below allows for Section 11 claims to proceed whenever some relationship between a purported error in a registration statement and a stock's decline in price is alleged. The plain language of Section 11(e), in contrast, allows for summary disposition of such claims whenever it is shown that the alleged error did not cause the decline. *Central Bank* instructs that, if the plain meaning and effect of a statute are to be changed, it is for Congress, and not the courts, to do so.

Finally, the Ninth Circuit expressed a policy concern that, in the absence of a broad "touch upon" approach to Section 11(e), "[c]ompanies and their auditors could immunize themselves from § 11 liability for false and even fraudulent financial statements simply by refusing to admit their falsity (or refusing to include in their adverse public disclosures information that would 'clue in the market' to their falsity) prior to the time a § 11 suit is filed." Pet. App. at A-31-32. This purported concern is misplaced. To the extent that management, auditors, or others intentionally attempt to omit or hide known material errors or falsehoods in their public disclosures, such conduct may be actionable under Section 10(b).[9] The potential for

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[8] A further decline in the price of the stock *after* the accounting error is disclosed, and *before* the Section 11 suit is filed (thereby locking in the floor price of the security for damages purposes), might be recoverable if the further decline, in fact, "results from" the disclosure of the error and not the lost sales due to the defect in the product or other business/market factors.

[9] *See, e.g., In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 925 (9th Cir. 1993) (alleging Section 10(b) liability against issuer and its

such conduct provides no principled basis for the Ninth Circuit to ignore the plain language of Section 11(e) and rewrite its own, broader causation standard.

III. EXPANDED SECTION 11 LIABILITY WILL HAVE ADVERSE CONSEQUENCES FOR THE INVESTING PUBLIC AND THE FINANCIAL MARKETS.

A. Expanded Section 11 Liability Invites Misuse Of The Statute As An Insurance Policy Against Bad Investment Decisions.

By vitiating the defense available to accountants and other defendants under Section 11(e), the decision below promotes misuse of the statute as an insurance policy against declines in the price of a security. "What must be understood, however, is that use of the securities laws to force accountants to provide insurance against stock price declines is not costless." *Regulation of Accounting*, 52 Brook. L. Rev. at 1054. The accounting profession already has suffered enormous litigation costs under the federal securities laws. The number of securities class actions against accounting firms has soared in the past decade. It has been reported that litigation-related costs of the Big Six accounting firms alone now exceed $600 million per year. Lee Berton, *Big Accounting Firms Weed Out Risky Clients*, Wall St. J., June 26, 1995, at B1 ("*Risky Clients*"). Even after insurance reimbursement, "these costs equal 12% of their annual audit and accounting revenue." *Id.*

The increase in securities litigation has led, in turn, to an insurance crisis in the accounting profession. Many

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officers and directors for failing to disclose the status of certain problem loans and filing "materially false and misleading reports with the SEC" in order to conceal the issuer's poor financial condition and thus maintain "inflated" stock prices), *cert. denied*, 115 S. Ct. 295 (1994). *Cf. Herman & MacLean v. Huddleston*, 459 U.S. 375, 386 & n.22 (1983) (the "effectiveness of the broad proscription against fraud in § 10(b)" is not limited or restricted by the express remedy under § 11).

insurers "are refusing to offer any coverage at all to accounting firms because the risks are too great and uncertain." *Who's Counting?*, Time at 50. Premiums for insurance that is available have increased as much as fifteen percent per year. *Id.* Deductibles have risen more than 471% since 1985, while policy limits have been steadily reduced. David A. Jaffe, *The Allocation of Fault in Auditor Liability Lawsuits Brought by Sophisticated Third Party Users of Financial Statements—A Plea for Proportionate Liability*, 54 U. Pitt. L. Rev. 1051, 1080 (1993). The increased risks posed by expanded Section 11 liability, therefore, cannot be offset through insurance.

B. Auditing Services Will Be Less Available To The Companies That Most Need Them.

Regrettably, the avalanche of securities litigation against accounting firms has required them to reduce or eliminate their auditing services for new ventures and other clients that are perceived to be too risky. Some accounting firms have stopped auditing IPOs altogether, while other firms have substantially limited the number of their IPO engagements. *See, e.g., Risky Clients*, Wall St. J. at B1 ("[t]he portion of all IPOs audited by [the Big Six] declined to 75% [in 1993] from 84% in 1992."). These clients are often the very start-up and growth companies "our country looks to for technological innovation, the bulk of job creation, and future competitive strength." *Hearings on Private Litigation Under the Federal Securities Laws*, 103d Cong., 1st Sess. (July 21, 1993) (statement of Jake L. Netterville, past Chairman of the Bd. of Directors of the Institute). *Cf. Central Bank*, 114 S. Ct. at 1454 (describing similar adverse consequences from expanded Section 10(b) liability).

Accountants also have begun declining audit engagements for financial-services companies and other businesses that have been the targets of significant securities litigation. *Id.* Increasingly, "[audit] refusals might well be done on an industry-wide basis because of the prohibi-

tive cost of acquiring sufficient information to distinguish more risky from less risky firms." John W. Hill & Michael B. Metzger, *Auditor Liability and the S&L Crisis: Shaping the Future of the Profession?*, 1992 Ann. Rev. Banking L. 263, 329-30 ("*Auditor Liability*").

C. Auditing Costs Will Continue To Increase.

The litigation risks facing the accounting profession have required firms to increase the costs for an audit. Because auditors cannot protect themselves from greater liability through insurance, they have been forced to raise their audit fees and take other measures that increase the costs of audits. Among other things,

> [w]hen calculating the price of their services, accountants will now charge for the insurance being provided. Similarly, accountants will take steps that do not increase the quality of monitoring services but create a paper trail that is of value in litigation. Such 'defensive accounting,' along with the cost of the insurance premium, will create higher prices. Investors, the supposed beneficiaries of securities fraud actions, will likely bear a large percentage of these increased costs.

Regulation of Accounting, 52 Brook. L. Rev. at 1054-55.

These higher audit fees also lead to "increased financing costs in [client] industries, and consequently to less growth, fewer jobs created and so forth. In the alternative, it could lead firms in such industries to turn to thinly capitalized, underinsured or uninsured auditors that lack the staff depth and expertise necessary to audit large clients effectively and that are more likely to lose their independence to a large client. Thus, audit quality may be reduced in industries most in need of effective third-party monitoring." *Auditor Liability*, 1992 Ann. Rev. Banking L. at 330. In the end, then, the investing public and the financial markets will suffer as a result of expanded liability against accountants under Section 11.

CONCLUSION

For the foregoing reasons, the Institute respectfully urges this Court to grant the Petition and to provide meaningful guidance on the proper application of the "loss causation" defense under Section 11(e).

Respectfully submitted,

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